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SUBJECT: CHILE'S ECONOMY: STRONG BUT BEGINNING TO FEEL THE IMPACT
OF THE GLOBAL FINANCIAL CRISIS

¶1. (SBU) SUMMARY: Chile's economic fundamentals remain strong, but economic growth will likely slow, negatively impacted by declining trade and investment, relatively high inflation, falling commodity prices, especially copper, and tightening liquidity. The peso's fall against the dollar, low foreign debt, fiscal discipline, and Chile's Sovereign Wealth Funds can help cushion negative economic effects. END SUMMARY.

Declines In Copper, Currency, And The Stock Market

¶2. (SBU) Chile has seen a week of precipitous drops in the price of copper, the exchange rate, and the stock market. The price of three month copper contracts on the London Metal Exchange has dropped 11% this week, and copper has hit is lowest price since February 2007 (dropping from a record high of $4.07 per pound in July 2008 to $2.45 per pound this week). The value of the U.S. Dollar has increased against the Chilean Peso by 43 Pesos in the last week (a depreciation of almost 8% for the Peso). The Peso has also dropped to its lowest level against the Dollar in four years. The IPSA index (Chile's equivalent of the Dow Jones Industrial Average) has lost over one fifth of its value in the last five days, falling almost 5% in one day alone, and reaching its lowest point since
¶2006.

Economic Growth Will Probably Slow But Remain Positive

¶3. (SBU) GDP grew 3.3% in the first quarter of 2008 and 4.3% in the second. The Monthly Index of Economic Activity, which compares variations in economic activity for the same month from year to year, increased 6.2% in July 2008, but only 2.4% in August (much lower than expected). The Ministry of Finance had forecast 5.4% growth in the third quarter, with annual growth at close to 4.2% for 2008 and 4% in 2009. However, the global financial crisis has caused many independent experts (and even some in the GOC) to revise their forecasts downward. Morgan Stanley recently decreased its estimate for Chile's 2008 GDP growth to 3.8%. Some analysts have said Chile will be lucky to grow by 3% in 2009.

A Global Economic Downturn Would Hurt Chilean Trade

¶4. (SBU) Trade has been one of the prime engines of growth for Chile, particularly given the huge role of copper exports (copper

accounted for almost 64% of exports in 2007, equivalent to roughly 25% of GDP). The vertiginous rise of copper prices in recent years has helped Chile run consistent trade surpluses until last month, which registered the first trade deficit since 2002. This was likely due to lower levels of copper production and high oil prices (Chile imports almost all of its oil). Chile's export sector is continuing to diversify, as trade volumes in non-copper products increase, but mostly in other commodities (e.g., woodpulp). Experts believe Chile must begin exporting more value-added products, which are starting to appear (e.g., firearms) but remain insignificant when compared with commodities.

¶5. (SBU) Many Chileans fear the current crisis will lead to a global economic downturn, which would reduce demand for Chilean exports. In 2007, 41% of Chile's exports went to Asia and 15% went to China alone (Chile's leading export destination). Copper products accounted for almost 90% of all exports to China. If Chinese growth alone were to slow, it would have a significant, negative impact on Chilean exports. Lower commodity prices could reinforce the impact (copper dropped to a 30 month low this month). Banks in Chile have reportedly calculated that a change of one cent in the price of copper will increase or decrease Chile's trade by approximately $70 million.

Depreciation Of The Peso Could Cushion Negative Effects
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¶6. (SBU) Since March 2008, the Chilean Peso has steadily fallen against the U.S. Dollar, accelerating during the financial crisis, to reach a 4 year low this month (a depreciation of nearly 20% in 2008). The Central Bank had embarked in April on an $8 billion program to purchase dollar reserves, which it halted when the

financial rescue package was unveiled in the U.S. The lower exchange rate will be a boon to exporters and may help cushion some of the effects of lower demand for Chilean products overseas.

Investment Has Been Healthy, While Consumption Slows
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¶7. (SBU) Investment has been steadily rising in Chile. In the second quarter of 2007, gross fixed capital formation grew 13% on the previous year, whereas the second quarter of 2008 showed a 23% increase for the same period. Consumption has slowed down. In the second quarter of 2007, total consumption registered an 8% increase on the previous year, but in the second quarter of 2008 it increased less than 6%. Sales of consumer goods also slowed, expanding 8% in the first half of 2007, but increasing only 4% during the same period in 2008. Rising inflation, tightening credit standards, and slower job creation were the main causes. In the second quarter of 2008, gross capital formation exceeded domestic savings for the first time in many quarters, possibly pointing to a move toward foreign savings as a source for investment. However, most analysts fear Chile will see a decrease in investment due to less domestic liquidity (more below) and a possible global economic downturn.

Inflation Is High, Monetary Policy Is Tightening
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¶8. (SBU) Relatively high inflation continues to dog the Chilean economy. In September 2008, inflation was 9.2% (as measured by the consumer price index) triple the Central Bank target rate. Core inflation reached 0.7 percent in August totaling a 9 percent increase in 12-months. In September, the Central Bank continued to tighten monetary policy, raising the interest rate to 8.25 percent, the highest rate since 1998. According to the President of the Central Bank, the increase was necessary to ensure convergence of inflation toward 3% over the policy horizon. Inflation expectations point to a slow decline in inflation over the next year. The Central Bank has repeatedly called inflation an "imported problem" linking it to persistent, high commodity prices (especially oil and agricultural products imported by Chile). A global downturn may help ease price pressures, but a continued depreciation of the Chilean Peso will also affect prices. Maintaining a contractionary monetary policy may prove difficult if the negative impact on the

real economy is significant.

Less Liquidity In Banks May Hurt Domestic Companies

¶9. (SBU) Although there have been no reports of exposure to mortgage-backed securities, liquidity has become a concern for Chilean banks. Before the crisis, the spread on international loans to Chilean institutions was relatively small (LIBOR + 10 basis points). Many international banks began to lend less or pull out of Chile in search of better returns. The spreads have increased (currently LIBOR + 27 basis points), but foreign banks have been slow to return. Anecdotal evidence indicates international lines of credit to Chilean institutions are drying up now. Chilean banks have tightened credit and raised interest rates on deposits to attract more capital. The week of October 6, the Central Bank announced a $500 million currency swap program to improve dollar liquidity and the Finance Ministry injected $1 billion into Chile's four largest banks.

¶10. (SBU) Large companies (especially multinationals) are reportedly taking out loans simply to ensure they have extra liquidity on hand in case it becomes necessary. This make liquidity even tighter for small- to medium-size enterprises (the majority of Chile's private sector), many of which depend on the loans for operating capital. Analysts fear this effect may accelerate, causing some Chilean businesses to curtail operations or even close, likely impacting unemployment. Chilean industrial production fell 3.1% in August 2008 compared with the same period in 2007 (mostly due to lower copper production). In August, unemployment was 8.2%, up from 7.2% in January.

Fiscal Discipline, Sovereign Wealth Funds May Help

¶11. (SBU) Chile's fiscal discipline has been an ongoing strength of its economy. The GOC is required to run a structural fiscal surplus of 0.5% of GDP (changed in 2007 from 1%). Chile has run budget surpluses for most of the past two decades. In 2007, the fiscal surplus represented 8.2 percent of GDP.

¶12. (SBU) The GOC has wisely chosen to keep windfall copper revenues (from the state-owned CODELCO copper company) outside of the economy in Sovereign Wealth Funds. In 2006, the Government created the Pension Reserve Fund (FRP) and the Economic and Social Stabilization Fund (FEES), estimated currently at a combined $21 billion. The GOC has also announced plans to create a third fund for education. Chile's fiscal discipline, relatively low foreign debt levels (35% of GDP in the second quarter of 2008), mounting reserves (11% of GDP in the second quarter of 2008), and Sovereign Wealth Funds, will likely protect the country from some of the effects of an economic slowdown.

SIMONS